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No. 90-1918

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In the Supreme Court of the United States

OCTOBER TERM, 1991

KRAFT GENERAL FOODS, INC.
(FORMERLY KRAFT, INC.), PETITIONER

v.

IOWA DEPARTMENT OF REVENUE AND FINANCE

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF IOWA

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

Whether Iowa discriminates against foreign commerce, in violation of the Commerce Clause or the Equal Protection Clause of the Constitution of the United States, by imposing its annual tax on the apportioned "net income" of corporations doing business in the State and by defining "net income" for this purpose to mean "the taxable income * * * as properly computed for federal income tax purposes under the Internal Revenue Code" (Iowa Code Ann. § 422.35 (West 1990)).

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This brief is submitted in response to the Court's order inviting the Solicitor General to express the views of the United States.

OPINION BELOW

The opinion of the Supreme Court of Iowa (Pet. App. 1a-10a) and its order denying rehearing (Pet. App. 57a) are reported at 465 N.W. 2d 664. The opinion of the district court (Pet. App. 11a-23a) is unreported. The order of the Iowa Department of Revenue and Finance (Pet. App. 24a-27a) (based upon a Stipulation of Facts (Pet. App. 28a-56a) adopted as the findings of the Director (Pet. App. 26a)) is unreported.

JURISDICTION

The judgment of the Supreme Court of Iowa was entered on February 20, 1991. A petition for rehearing was denied on March 19, 1991 (Pet. App. 57a). The petition for a writ of certiorari was filed on June 14, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1257(a).

STATEMENT

1. Petitioner is a Delaware corporation with its principal place of business in Illinois.[1] Petitioner conducts a unitary business throughout the United States and, through its foreign subsidiaries, in certain foreign countries (Pet. App. 28a-29a, 33a). Petitioner is qualified to, and does, conduct business in Iowa.

On June 3, 1985, the Director of Revenue of the State of Iowa issued a notice of assessment to petitioner for taxes, interest and fees due for 1981 in the aggregate amount of $51,756.62 (Pet. App. 32a-33a). The assessment was made under Section 422.33 of the Iowa Code, which imposes an annual tax on the apportioned "net income" of corporations doing business in the State (Pet. App. 3a, 58a). Section 422.35 of the Iowa Code (Pet. App. 62a), with adjustments not at issue here, defines the term "net income" as "taxable income * * * as properly computed for federal income tax purposes under the Internal Revenue Code of 1954." The Iowa Code thus incorporates federal standards for determining "taxable income" in deriving taxable "net income" for state purposes.

[1] Petitioner is the successor by merger of Kraft, Inc., also a Delaware corporation that during the calendar year 1981 had its principal office and commercial domicile in Illinois and was qualified to do business in Iowa. References in this brief to "petitioner" are either to the corporation active at the time described or to both corporations.

Under the Internal Revenue Code, dividends received by a corporation are included within its "gross income." 26 U.S.C. 61(a)(7). In computing "taxable income," however, a corporation may deduct 70% (formerly 85%) of the dividends it receives from another *domestic* corporation and may deduct 100% of the dividends it receives from a *domestic* corporation that it controls by ownership of at least 80% of its stock. 26 U.S.C. 243.[2] Dividends received from a *foreign* corporation or subsidiary, however, are *not* deducted in determining the "taxable income" of a corporation under the Internal Revenue Code. Instead, the Code provides an election to the corporate taxpayer either to deduct the foreign income taxes that it has paid on its own foreign operations (26 U.S.C. 164(a)(3); see note 3, *infra*) or instead to take a tax credit based on the amount of foreign income taxes it paid and on the amount of foreign income taxes paid by the foreign corporation that paid dividends to the taxpayer (26 U.S.C. 901, 902).

As a result, when a corporate taxpayer receives dividends, whether from domestic or from foreign corporations, the Internal Revenue Code requires that the amount of those dividends be included in gross income, but then, in computing "taxable income", allows a deduction of 70% or 100%, as the case may be, of the amount of dividends from taxable domestic corporations. In basing its corporate income tax upon an apportioned fraction of "net income", defined as "the taxable income * * * as properly computed for

[2] "Domestic corporations" are defined as corporations organized under the law of the United States or any State. 26 U.S.C. 7701(a)(4).

federal income tax purposes," Iowa to that extent accepts and follows the federal pattern.

During 1981, petitioner owned more than 80% of the stock of several corporations organized and conducting their respective segments of petitioner's unitary business exclusively outside the United States. Six of these foreign subsidiaries paid dividends in that year in the aggregate amount of $10,181,815, of which, after foreign income taxes were withheld, petitioner received $8,690,928 (Pet. App. 52a-53a).[3] In computing "net income" on its Iowa corporate income tax returns for 1981, petitioner deducted from its reported federal "taxable income" the dividends it had received from its foreign subsidiaries (*id.* at 32a). The deficiency assessed by the Director of Revenue of the State of Iowa required these foreign dividends to be included in petitioner's "net income" because such dividends could not properly be deducted in computing "taxable income" under the Internal Revenue Code (*id.* at 32a-33a).

Petitioner protested the asserted deficiency of the Iowa State Department of Revenue and Finance. Petitioner asserted that inclusion of the dividends it received from foreign subsidiaries in its net income discriminated against foreign commerce, in violation of the Commerce Clause (Art. I, § 8, Cl. 3), and

[3] The petition does not disclose what fraction of petitioner's net income is apportioned to, and taxed by, Iowa. The stipulated facts also do not reveal whether petitioner itself engaged in business beyond, as well as within, the United States. In conformity with Rule 29.1 of the Rules of this Court, petitioner lists 87 subsidiaries other than wholly owned subsidiaries (Pet. App. 76a-79a). The names of the 87 suggest that most, if not all, are foreign corporations. The list does not include the six subsidiaries (identified at Pet. App. 52a-53a) whose dividends are at issue in this case.

denied petitioner the equal protection of the laws, in violation of the Fourteenth Amendment to the Constitution of the United States. The Director of Revenue and Finance denied the protest, noting that he had no authority to decide the constitutionality of the State's laws (Pet. App. 24a-27a).

2. The District Court of Polk County, acting on the basis of a stipulated record (Pet. App. 28a-56a), upheld the assessment issued by the Director of Revenue and Finance (*id.* at 11a-23a). The court held that "Kraft has not shown that the Iowa tax in any way benefited local in-state industry in detriment to out-of-state industry" (*id.* at 16a) and "has not shown that the Iowa tax exerts a pressure on interstate business to conduct more of its activities in Iowa" (*id.* at 17a). The court characterized as "wholly speculative" the argument that, if other States followed the Iowa pattern, "it would be a 'powerful persuader' to locate foreign operations within U.S. borders" (*ibid.*). The court therefore rejected (*id.* at 22a-23a) petitioner's equal protection and Commerce Clause claims.

3. The Supreme Court of Iowa affirmed (Pet. App. 1a-10a). In response to petitioner's charge that the Iowa corporate income tax discriminated against foreign commerce, the court stated that "the question is whether Iowa businesses are benefited at the expense of foreign businesses" (*id.* at 7a) and concluded that "[b]ecause the Iowa tax does not differentiate between in-state or out-of-state taxpayers, no impermissible discrimination exists" (*id.* at 7a-8a). The court also rejected petitioner's equal protection claim, noting (*id.* at 9a) that no suspect classification or fundamental right was at issue in this case and that use of the federal concept of "taxable

income" served legitimate state purposes (as well as the convenience of taxpayers) in promoting economy of effort, convenience, and administrative efficiency (*id.* at 9a-10a).

DISCUSSION

1. The facts of this case parallel those of *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425 (1980), in which this Court upheld application of Vermont's corporate income tax to dividends received by a domestic corporation from foreign subsidiaries and affiliates. As petitioner acknowledges, Vermont's corporate income tax operates "in identical fashion with Iowa" (Pet. 7). In the *Mobil* case, this Court rejected the claim that, by taxing dividends received from foreign subsidiaries of a unitary business,[4] the Vermont statute unconstitutionally burdened foreign commerce. 445 U.S. at 446-449. The Court concluded that "the source of the income" (*id.* at 438) was not material in determining the State's power to tax. *Ibid.*

The claim in the present case differs from *Mobil* only in two respects: (i) the taxpayer now concedes (as it must) that the State has *power* to tax dividends received from foreign affiliates; and (ii) the taxpayer now claims instead that the *manner* in which the tax is imposed results in an unconstitutional discrimination against foreign-derived dividend income. That the two cases differ only to this limited extent

[4] A "unitary" business is one whose operations are sufficiently integrated on a regional, national or international scale that it is proper, for tax purposes, to apportion the income of the entire business unit among the states or regions affected. See *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. at 432, 437.

does not deny to petitioner's argument whatever intrinsic merit it may possess. It does, however, suggest that the "facial" constitutional flaw now urged by petitioner (Pet. 9) was not sufficiently apparent to provoke consideration by Court or counsel in the *Mobil* case.

2. a. In defining "taxable income" for corporations, the Internal Revenue Code differentiates in its treatment of dividends received from domestic corporations and foreign corporations. See pp. 3-4, *supra*. Dividends that a corporation receives from another domestic corporation are excludable (in part or in whole) from the "taxable income" of the recipient; dividends that a corporation receives from a foreign corporation are not excludable. See *ibid.*[5] The reason for this different treatment is that the income of a domestic corporation has already been subjected to a federal tax before it pays dividends, but the income of a foreign corporation has not.[6] By providing for

[5] As this Court pointed out in *Container Corp.* v. *Franchise Tax Board*, 463 U.S. 159, 184-185, 187 (1983), the United States (as well as most States and foreign governments) ordinarily treats separate corporations, even if closely related, as independent entities for purposes of taxation. There are some special and limited exceptions, such as foreign personal holding companies (Sections 551-558) and so-called "Subpart F" income of controlled foreign corporations (Sections 951-965), that receive special treatment. See *Eder* v. *Commissioner*, 138 F.2d 27 (2d Cir. 1943) and *Garlock, Inc.* v. *Commissioner*, 489 F.2d 197 (2d Cir. 1973), cert. denied, 417 U.S. 911 (1974).

[6] Section 23(p) of the Revenue Act of 1932, ch. 209, 47 Stat. 182, made sure that the deduction was available only if the dividend-paying corporation was "taxable under this title." See H.R. Rep. No. 708, 72d Cong., 1st Sess. 12 (1932); S. Rep. No. 665, 72d Cong., 1st Sess. 16 (1932)

special treatment of dividends received by one domestic corporation from another, the federal scheme avoids a "double tax" on the corporate income stream. See 3 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 90.2.3, at 90-16 (1981) (the statute avoids the "multiple taxation of corporate earnings as they passed from one corporation to another, possibly within the same chain of beneficial ownership").[7]

After federal "taxable income" has been computed under these rules, a credit is allowable under the Internal Revenue Code against the tax due on the foreign dividends received by a corporation. The credit is based on the amount of foreign income taxes that the foreign corporation has paid on the income from which its dividends were distributed. See 26 U.S.C. 901, 902. Because of differences in foreign and domestic tax rates, this credit does not necessarily (or even often) result in identical tax treatment of the income stream of domestic and foreign subsidiaries of a United States corporation. Cf. *United States* v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989). The resulting differences in the tax treatment of domestic and foreign entities is the unavoidable product of practical international realities. It has never been suggested to effect an improper discrimination

[7] For dividends received from foreign corporations, the situation is entirely different. The earnings of foreign corporations not doing business in the United States have not been subjected to tax in the United States; they become subject to taxation in the United States only when paid as dividends to United States taxpayers. There is differentiation, but not discrimination, in (i) taxing domestic corporate earnings at the initial level but not when distributed to another corporate entity, and (ii) *not* taxing foreign earnings at the initial level but subjecting them to tax when paid as dividends to United States taxpayers.

between domestic and foreign source income at the federal level. See note 7, *supra*.

b. Iowa accepts the result produced by the federal "taxable income" definition for corporate dividend income. Iowa does not, however, follow the federal practice of allowing a credit for foreign taxes paid against the foreign dividends received by a unitary domestic corporate enterprise.[8] The Iowa scheme thus effects a greater differentiation in the treatment afforded to foreign and domestic dividend income than results under the Internal Revenue Code.

The degree or amount of the difference between the actual tax burden imposed on domestic and foreign source income under the Iowa scheme, however, is not addressed in the record of this case. While the Iowa scheme, like the federal scheme, "facially" (Pet. 9) differentiates between the two types of dividends, that does not necessarily imply that the total income stream of a foreign subsidiary is subjected by Iowa to a greater or lesser total tax burden than that of a domestic subsidiary of the same unitary enterprise.[9]

[8] In *Mobil Oil Corp.* v. *Commissioner of Taxes*, the Court observed that, "[a]bsent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States." 445 U.S. at 448.

[9] The factual variations are almost limitless. See Br. in Opp. 8-11. If the dividends from domestic corporations that are excluded from petitioner's net income under the federal and Iowa rules are paid from income that is taxed by Iowa and other States on an apportioned basis, the tax burden on domestic corporate income may well *exceed* that of the burden on foreign source income under the Iowa tax scheme. There is also no evidence in this case of the treatment afforded by foreign national and local governments to similar items of income. In this context, petitioner's assertion of a "facial"

There is thus no inescapable logic to petitioner's claim that a "facial" difference in treatment by Iowa necessarily results in a greater tax burden on foreign source income. It may, or it may not. See notes 7, 9, *supra*. There is, similarly, no inescapable logic to petitioner's claim that a "facial" difference in treatment by Iowa *necessarily* discriminates against foreign commerce. Here, as in *Container Corp.* v. *Franchise Tax Board*, whether "the combination of the [state, national and foreign] methods" of taxation results in the same income being taxed more heavily when earned by a foreign or domestic subsidiary "is dependent solely on the facts of the individual case" (463 U.S. at 188).[10]

In this case, petitioner elected—presumably for sound tactical reasons—to present its case on a theory of "facial" rather than "actual" discrimination. That election deprives the Court of any ability to assess (i) the degree (or even the existence) of any burden that the Iowa scheme may systematically impose on foreign commerce and (ii) the degree (or even the existence) of any systematic preference that may result to domestic commerce under the Iowa scheme. Since the record of this case does not provide a suitable factual context for evaluation of the claimed con-

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discrimination against foreign commerce is, as the lower courts held, entirely "speculative" (Pet. App. 17a).

[10] In *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. at 446-449, this Court disposed of the suggestion that application of the State's apportioned income tax to foreign dividend income received by a unitary corporate enterprise runs afoul of the principles articulated in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979). Petitioner's invocation of *Japan Line* (Pet. 12-15) adds nothing to the argument that the Court rejected in the *Mobil* case.

stitutional issues, and since there is no conflict in the decisions of state or federal courts on the specific question actually presented in this case, further review is not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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DECEMBER 1991

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